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THE U. S. AND THE IMPENDING ENERGY CRISIS

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Summary and Conclusions

The world is now experiencing what is very likely its last brief buyers' market for conventional oil. By 1975, and possibly earlier, we will have entered a permanent sellers' market, with any one of several major producers being able to create a supply crisis by cutting off oil supplies. The United States itself can see its current relatively comfortable energy position continuously deteriorating to the point where, by 1980, it will be forced to import half of its oil requirements -- largely from the Eastern Hemisphere.

The United States and its allies survived the current OPEC crisis without undue damage by a show of consumer solidarity and by diplomatic persuasion in several of the OPEC countries. The prospects of success may be small and shortlived, even if achieved, unless the oil companies are willing to discuss with the producing governments some form of a new relationship after 1976.

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The US and its allies have small chance of forcing OPEC to retreat from its position. The oil producers will have to be convinced that they are obtaining a satisfactory return from their oil resources and that they have more to gain by stability over a long period than they can by creating chaos and high short term profits.

The USG should no longer delay action while studying our energy problems and should start taking action. We have had numerous studies and should continue to study and review our energy problems but not at the expense of delay. Decisions must be taken in the United States within the next two years which will enable us better to secure our own needs in energy for the next two decades. These decisions, involving efforts to reduce rates of growth of consumption and to raise domestic production and imports from secure sources, will be as unpopular as they will be costly. They will require a good deal of political courage, and the State Department should explain the need from a security and foreign relations point of view.

Action in the OECD to follow coordinated policies on energy matters, and action in producing countries to persuade them to adopt policies which will insure stability

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in world oil supplies at predictable prices, should constitute a major diplomatic activity of the United States in the next two years.

The short-run problem of the current OPEC demand for revision of payments as a result of the dollar "devaluation" can probably be met only by the companies agreeing to some higher posted prices, or some new basis for payments. The companies are already showing considerable flexibility here.

The second current OPEC demand for "participation" will be more difficult. The companies believe it is in contravention of the Tehran agreements and we agree. Most of them will resist the demand and we should give them diplomatic support. We believe, however, that it will be possible successfully to forestall OPEC action which could go as far as confiscation of properties, only if the companies are willing to start now discussing new company-government relationships after 1976.

If it should not be possible to delay the current moves toward participation until after 1976, the end of the Tehran agreements, the timetable for working out new producer-company-consumer relationships might have to be advanced. A steady supply of oil on reasonable terms, i.e., terms consumers can pay and can count on over an extended period, is of first importance.

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I. Preamble

Over the last four years, officers of the Department of State have discussed the subject of the future of the international oil industry with officials of almost all of the oil companies which have interests abroad. Such discussions have been ad hoc and generally have been centered around events of immediate urgency. In 1970 and early 1971, the discussions grew in frequency, although they remain unstructured with no agenda and few conclusions; and there were no recommendations for action. In July 1971, in an effort to focus attention more sharply on the subject, particularly on goals and on actions which might be taken by the industry and the government to achieve these goals, we drafted and sent to the industry a series of questions (Annex 1). The questions were not meant to be exclusive or to indicate any course of action; they were merely indicative of the problems which would have to be faced and answered before there could be any serious planning for the next decade.

In the last four months, we have had meetings with the five American majors, Gulf, Mobil, Standard Oil of California, Standard Oil of New Jersey, and Texaco; with Shell (but not with British Petroleum); with five large "independents", Atlantic Richfield, Continental, Marathon, Occidental and Standard Oil of Indiana. The questions were sent to several other independents but, at this writing, no response has been received. The questions

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were also discussed with officials of Chase Manhattan Bank and First National City Bank of New York, and with Walter Levy. At various other times, the broad subject, but not the specific questions, was discussed with a substantial number of other officials of the companies listed above and with officials of overseas affiliates of most of them. The total number of individuals who contributed their views on the specific list of questions was about 100. Conversations on the same subject were held during the last year with an additional 100 company officials.

Some companies had given a great deal of thought to the subject of changing conditions in company-government relations in producing and consuming areas; others apparently have preferred not to try to anticipate events. With a few exceptions, however, it is not possible to speak of an unflawed, monolithic "company position". Feelings and attitudes inside most companies, as in the Department of State -- not to mention the Federal Government -- vary considerably. And finally there are fairly well known differences in approach and attitudes among the top executives of the industry as a whole; some traditionally have taken a quite rigid line, others a more compromising one. In this report, the specific views of no company and no individual will be identified.

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We have also sent the list of questions to and asked the views of our posts in OPEC capitals and in the main consuming centers. Their responses have also been incorporated in this paper.

II. Goals of the Companies and the Government

The first objective of the consultations with the industry was to try to define our goals. We hope that, in the course of the study, the concerns of the industry have been answered, and industry now sees that its interests are, although not identical to, consistent with those of the U.S. Government. If the fate of the oil industry were a matter of indifference to the government, there would be no need for such a study, or for any proposals of action by the companies or the governments. We would, with equanimity, let the companies move toward their inevitable confrontations with OPEC and perhaps other consumers; we would be nothing more than mildly interested observers. Such, of course, is not the case. The U.S. Government does indeed wish to see the uninterrupted flow of oil, but so do the companies.

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One of the traditional and most important functions of the Foreign Service has been to protect American investment. This has not changed. The contribution of the international oil industry to our balance of payments is about as great as that of all other investments abroad combined and, hence, is another reason for our concern that our oil companies remain healthy and productive. The United States Government is as interested in the continuing discovery and production of new oil as are the companies themselves; and we are highly skeptical of the chances of oil being found or developed if the international industry is removed from the production of oil or even if its role were severely curtailed.

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In short, the industry and the government both wish to see a continuing major role for the U. S. industry in foreign oil production, as well as in transport, refining and marketing. The government and the industry are equally concerned about the need to have a stable atmosphere in which the companies can find and develop new oil reserves, and both believe that a considerable effort will have to be made by both government and industry to achieve the goals of stability and growth in world oil supplies.

This having been said there is a wide divergence of opinion on how best the goals could be achieved. The 200 oil company officials and other with whom we spoke could be broadly divided into five groups:

1. Those who say that the present concessionary system is good -- that any change will be for the worse, and that the only thing the companies should do is resist change with all the forces at their command. The only function of governments -- the consuming governments of Europe and Japan as well as the United States -- would be to back the companies in their confrontation with the producing governments of OPEC.

2. Those who say that change is probably inevitable, but must be resisted at every step. Anything which is given too soon means profits which are foregone. This group believes that they can most successfully prolong their

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concessions in oil production by yielding only when absolutely forced to do so.

3. Those who believe change is inevitable, and who are willing to go gracefully into a new era -- but may not themselves volunteer any modifications in agreements.

4. Those who are convinced that because changes will be forced on the industry, it would be preferable to anticipate demands and to make new offers of new relationships to at least some of the OPEC countries. This would create a friendlier atmosphere for talk and might enable them to reach better arrangements than if forced into a hostile confrontation.

5. Those who believe that complete nationalization is inevitable and will probably be soon. The companies should therefore start planning now their new role as purchasers of crude from national oil companies.

All five positions have defensible aspects. Why yield something which is not immediately required? And yet most recognized that intransigence could provoke hostile action -- even complete nationalization -- which could not be resisted. If the future could be seen perfectly, all five groups would meld into one: just before change would be imposed, the companies would yield just enough to keep the producing governments satisfied. Unfortunately, none in government or industry is clairvoyant, and the cost of yielding too soon must be set against the danger of holding out too long. Weighing these alternatives and making recommendations for action is the second objective of this paper. The recommendations will be based on facts as far as we can know them, but the interpretation of these facts will inevitably be subjective.

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III. Reserves, Production and Demand

A. Primary Reserves

Between two-thirds and three-fourths of the non-communist world's known reserves of oil are in the Arab countries of North Africa and the Middle East. The figures in the table below are generally accepted by the industry as reasonably accurate.

Reserves in billions of barrels:

U. S.	40	
Canada	10	
Venezuela	15	
Other Latin America	15	
Total Western Hemisphere		80
Arab World *	350	
Iran	55	
Indonesia	10	
Non-Arab Africa	10	
Other	5	
Total Eastern Hemisphere		430
Total Non-Communist World		510

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* More than half of the Arab total is in the Arabian Peninsula (Saudi Arabia, Kuwait, the Trucial States and Oman). Some geologists maintain that the deGolyer and McNaughton estimate for Saudi Arabia of 130 billion barrels is underestimated; that the known reserves are considerably higher and that the probable recoverable reserves of that country are at least twice and possibly thrice this figure. The estimate used for Iraq of less than 30 billion barrels is also low; and the probable recoverable reserves are at least 100 billion barrels. There is a fairly widespread belief in the industry that by 1985 the production of all countries of OPEC except Saudi Arabia and Iraq will have "peaked-out" and will have started to decline, unless they have converted to secondary recovery methods.

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The table above is a matter of considerable concern to the consumers of oil and to the oil companies which are devoting almost all of their exploration expenditures to areas outside the middle East and North Africa. They are looking for oil in Southeast Asia, in the Canadian and Alaskan Arctic, in the North Seas, in South America, indeed, wherever there are attractive sedimentary basins. But the fact remains that the great bulk of the world's conventional oil is in an area in which there are strong elements of insecurity and even hostility.

B. Supply and Demand

The United States currently produces around 12 million barrels a day of the 15.5 million b/d of oil it consumes. By 1980, if there is no strong government action to reverse these trends, the United States will be consuming around 24 million barrels a day of oil,* but will be producing very little if anything more than at present. This includes the assumption that 3 million barrels a day will be produced in Alaska. Of the remaining 12 million barrels a day, very little more than one million could be imported from Canada, unless the United States and Canada are able to reach an energy agreement which would encourage Canadian oil

* Estimates vary from 22 million barrels/day (Department of the Interior) to 26 million barrels/day (Chase Manhattan) and depend on a large number of assumptions -- most important of which is the state of the economy during this decade.

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production. Perhaps two million additional barrels per day could be imported from other Western Hemisphere sources. This would leave a total of 9 million to be imported from the Eastern Hemisphere, largely from the Middle East and North Africa.

The probable world production and consumption figures in 1980, as compared with 1971, are shown in the following table. They are based on the assumption that there will be an essentially laissez faire policy by most producer and consumer countries, no major disruption in the producing areas, and no major economic recession.

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Figures in Millions/Barrels/Day
(Non-Communist Countries Only)

	Consumption 1971	Consumption 1980 2)		Production 1971	Production 1980
U. S.	15.6	24	U. S.	12.0	13
Western Europe	13.4	27	Total Arab	15.4	35
Japan	4.8	13	(Arab-North Africa)	(4.8)	(6)
Others	10.2	16	(Arab-Middle East)	(10.6)	(29)
Total	44.0 1)	80	Iran	4.3	12
			Venezuela	3.8	4
			Others	7.5 3)	16 4)
			Total	43.0	80

1) The difference between total consumption and production figures is covered by 1 million b/d imports from Communist countries.

2) Assumes Soviet Union production/consumption in balance; i.e., essentially none will be exported and none imported, or imports will balance against exports. British and NATO studies indicate that the Soviet Union will continue to export around 800,000 barrels a day to the non-Communist world in 1980, as it does today.

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These figures are compatible and well within the range of error in predictions for 1980. In any case, it seems unlikely that either Soviet need for oil or Soviet competition with the OPEC producers of oil will soon be important considerations. The Communist countries of Eastern Europe, however, may, by 1980, import as much oil from the OPEC countries as they do from the Soviet Union. But given the very small base at which they begin, they are not likely by that time to be major factors in the world oil scene.

3) Includes 1.6 million b/d in Canada, 1.9 in other Latin America, 1.9 in Western Africa, and 1.5 in S. E. Asia.

4) Includes 3 million b/d in Canada, 2.5 in other Latin America, 4.5 in West Africa, and 3 in S. E. Asia.

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Petroleum seems to be remarkably price-inelastic. This, however, has been true only of fairly small changes in petroleum prices. When gasoline prices in the United States have gone up by 2 cents a gallon, there has been no noticeable decrease in gasoline consumption. Essentially the same is true in Europe. If, however, we were to see very substantial changes in prices - for example, if there were to be an increase in gasoline tax in the United States of 20 or 30 cents a gallon, there would surely be some drop in consumption, and there would certainly be some switch to smaller or more efficient engines. If ex-tax prices in Europe and Japan increase to something close to the American domestic price; that is, if the delivered price of crude oil in Europe and Japan were to increase from the current $2.50 to (say) $3.50 a barrel, then consumption of oil would probably be decreased there, too. The question is how much would it be decreased? * An OECD study of the elasticity of demand for oil, with substantial increases in prices, might be a worthy project.

C. Conventional Oil from Non-Arab Sources

The picture could be quite different as far as the United States is concerned if action were taken now to ensure for ourselves new sources of energy and more efficient use of available oil. For example, the United

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* Even in Europe there is very little empirical data on this subject. British gasoline taxes were raised by an equivalent of 10 U.S. cents/U.S. gallon shortly after the Middle East War of 1967. Consumption dropped somewhat but rose quite rapidly and within six months was almost exactly at the point which had been projected before the taxes had been raised.

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States could import much more from Latin America if the political and economic climate in those countries, notably in Venezuela, were such that the investments could be made to find and develop new reserves. Similarly, an energy agreement with Canada could result in substantially greater production and exports to the United States.

The discoveries of hydrocarbons in the North Sea have been extremely important and production from that source may have been underestimated. It might reach 2 million barrels a day in 1980, (one source estimates it could be as high as 3 million) but as total Western European consumption will be around 26 million barrels a day at that time, North Sea production would still be small compared with imports. There has been a great deal of exploration for oil in Indonesia, but the first high hopes there have not materialized. This does not augur well for the prospects of the rest of the East Asian offshore areas.

All companies agreed that there is almost certainly a large quantity of oil on the Outer Continental Shelf of the United States. It will, by definition, be impossible to develop it until leases are given beyond the 200-meter isobath. The present U. S. Government

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policy of giving no leases beyond that depth may inhibit the development of the technology which will be required to recover this oil. However, in order for the granting of leases beyond the 200-meter depth to be consistent with the President's Oceans Policy Statement of May 23, 1970, such leases must be granted subject to the international regime to be established by the United Nations Law of the Sea Conference which is presently scheduled for 1973. Nonetheless, several companies are now working on means to finish oil drilling on the ocean floor. Whenever this research is successfully completed, the depth restriction, from a technological view, which is now set by the limits on the length of the legs of drilling platforms, will be removed and it would be possible technically to go to 2,000 meters or even deeper; in other words, on to the Continental Rise. In any case, a policy of leasing in the deep sea would encourage development of this technology.

All this is relatively comforting for the United States -- but it will do relatively little for Europe or Japan, and their dependence on the Middle East has

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every likelihood of remaining almost as complete as it is today. Two-thirds of their present consumption and one-third of the non-communist world production now comes from these countries; by 1980, three-quarters of Europe's and Japan's supplies and almost 60 percent of the non-communist world's supplies will come from them. The absolute increases are even more striking as consumption will almost double during that period.

It would be pointed out that, up to this point, we have referred only to production from what shall be called here, "primary reserves". That is, oil that flows out of the ground under its own pressure, and whose cost of production is extremely low. A good deal more oil, perhaps two or three times as much, could be recovered by more expensive secondary and tertiary recovery means in the Middle East.

D. Non-Conventional Oil

There are other major sources of hydrocarbons outside the Middle East. For the purposes of this report, they shall be called "secondary reserves" (this should not be confused with "secondary recovery").

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These are the heavy oils of Venezuela and the tar sands of Canada and the United States; and the reserves are enormous. Venezuela certainly has a trillion barrels in its heavy oil belt, and possibly as much as 3 trillion. There may be a trillion barrels or more of oil in the tar sands of Canada. Although only a small proportion of this can be produced with present technology, 10 percent recovery (a completely reasonable figure) of a trillion barrels is a hundred billion barrels, or two and a half times present U.S. reserves. The cost of recovery of this oil is considerably higher than from "primary oil reserves." The Venezuelan heavy oils, for example, could not be recovered economically with today's taxes in Venezuela and sold on the world market. Neither could the oils from the Athabasca tar sands in Canada.

It will probably take a slight rise in U.S. prices, along with free entry into the U.S., to make the Athabasca oil profitable.

Finally, there are the "tertiary reserves" represented by shale and by coal. It is here where the United States is most blessed. The reserves of shale in the United States are probably the greatest in the world;

estimates of quantities vary, but most agree there are the equivalent of well over a trillion barrels of oil in place. Our coal reserves are almost as big as those of the rest of the world combined. Oil produced from shale or from coal is even more expensive than that of the "secondary reserves", but there is a wide variance of opinion on what the costs would be. Some believe oil from shale or coal could be produced profitably at prices only slightly above today's crude oil prices, say $4.00/barrel. Others believe the figure would be much closer to $5.50/barrel. One aspect of shale oil which does not always figure into cost estimates is the fact that production of small quantities of oil from shale, with little or no overburden and with adequate water available, may actually be less costly than would be production of large quantities of oil from shale. A large-scale operation would require deep mining or the removal of enormous quantities of overburden, and enormous quantities of water.

There is also a considerable difference of opinion on whether oil will be produced in large quantities first from shale or from coal. Opinion seems to be divided almost evenly on lines of interest; those who have large shale holdings believe shale will come first; those with significant positions in coal reserves insist that the problems of coal conversion are much simpler and the ultimate costs will be lower than for oil from shale.

In any case, there can be very little doubt that the hydrocarbon needs of the United States will ultimately be at least partially covered

by oil produced from these two sources, or that these are the major reserves of the world. They are also the most costly of the reserves we are presently considering.

E. World Price of Oil Set by Cost of Production of Synthetic Oil

When oil is produced in large quantities from synthetic sources at high prices, there can be little domestic argument for keeping conventional oil prices low. Even if this were done, and it could be if oil prices were controlled as are gas prices by the FPC today, there is no reason to believe that the prices OPEC countries would command could be as easily controlled. We could put high import duties on imported oil, but it is impossible to believe that the major producers of oil, assuming oil is in short supply, would be easily reconciled to letting the U.S. Government cream off the difference between the "real" value of the oil as expressed by the cost of shale or coal conversion, and the cost of imported oil. OPEC has noted repeatedly the income European governments get from excise taxes on petroleum products. They say that the consuming governments take far more revenue from the "OPEC barrel" of oil than do the producing governments, even after the recent negotiated price increases. The consuming governments' argument that they are free to set taxes at any levels they wish, and that domestic taxes are irrelevant to prices charged by producers, is not entirely convincing to the producing governments. The producers' position is that the true value of the oil and

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its products is expressed by the retail value of the product in the markets, including taxes and duties. The consumer, by definition, is willing to pay these prices and therefore he has already set the value for the oil. The only other pertinent factor is the cost of alternative sources of energy.

While the cost of shale and coal conversion may be a major factor in influencing producing governments to raise oil prices, it very likely will also place an upper limit on the price of conventional oil. With vast quantities of shale and coal available, it can be presumed that, in the long run, consumers would switch to oil from these sources if conventional oil prices were to rise above the cost of synthetic oil production. This is not to imply that the entire world could or should be supplied by the coal and shale and tar sands of the North American Continent -- at least not in the foreseeable future -- but a reasonable case can be made for producing the marginal barrel of oil from these sources by 1980 or 1990 if world prices rise above the cost of producing synthetic oil.

The sources or type of oil is today largely a question of economics. Technology has already advanced

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to the point where oil can be produced from the Athabasca tar sands (indeed it is already being produced in small quantities), from the heavy oils of Venezuela or from the coal or shale in the United States; it is primarily the cost of this oil which inhibits its production. If the decision were to be taken to produce oil from these non-conventional sources, then dependence of North America on Eastern Hemisphere oil could be reduced. Theoretically, oil could even be exported today. The Japanese reportedly have been looking into the prospects of producing oil from the Athabasca tar sands, but this is of questionable economics and we are not certain if the Japanese are serious.

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IV. The Conventional Concessions

The present concessionary system has worked very well. It is a tried and predictable system. It has permitted the efficient development of oil fields in large blocks. It has given a great deal of operational flexibility, and has assured the consumers of long-run stability in their supplies. It has enabled the producing governments to open up large areas to development and has been responsible for their economic development, which in many cases has been dramatic. The system has provided a floor for the revenues of producing governments and has made it unnecessary for them to become involved in the marketing of petroleum.

The companies provide the necessary capital and the technology to produce the oil. The producing governments supply land and the resources. The attitude, common 60 or even 20 years ago, was that the oil companies made the resource; without their efforts, science and capital, the oil would stay in the ground. The producing countries, therefore, should welcome the efforts of the companies. There are some who still hold to this view, but most have modified their views. In fact, the concessions have in no way been rigid documents but have been amended frequently over the course of the last 30 years, almost invariably to the benefit of the producing government.

Unfortunately, there are still many in the governments and universities of the producing countries who have not seen that the oil companies have changed. They seem to believe that the companies are interested only in as rapid exploitation of the resource as they can manage, with as little as possible given to the government and the people of the country. But no matter how farsighted the company management, the inescapable fact is that, excepting the newer joint ventures, the companies exploiting the concessions in OPEC today are alien to the producing areas. They got their concessions some time ago and they set up their establishments, frequently very large ones, some of which have had many of the aspects of an extra-territorial settlement. Indeed, the Arabic word for concession (imtiyaaz) is the same as the traditional Ottoman word for "capitulations" and many, particularly in the Arab world, consider the concessionary companies as very little different from those foreign communities established in the Ottoman Empire a hundred years ago.

There is no disputing the facts: the foreigners come; they produce oil; they give the governments money -- large quantities of it. But instead of expressing gratitude to the oil companies for their generosity and their initiative, the new nationalists say with increasing frequency that the concessionary system is degrading. That the government must have the final say over its own economic destiny is the new nationalist

watchword, and the nationalists believe that the only way this can be achieved is by controlling the oil companies which operate within their boundaries.

Probably without a single exception, the producing governments also have the idea that the profits made by the exploitation of oil in their countries are exorbitant; even with the new profit splits of 60-40 in favor of the producing governments (or 80-20 when based on realized prices) the governments look on company profits and on the total value of the investment in their countries and compare them with "normal" commercial returns of 10 or 15 percent. They conclude that the companies' profits are entirely out of line with usual business practices. Some of the fault of this, of course, lies with the companies or with tax regulations in the United States and elsewhere, which make it to the advantage of the companies to ascribe all or a large part of their profits to the production end and to show relatively little profit on the downstream operations. The fact that industry returns on total investment from production wells to gasoline pumps is less than general returns in the manufacturing industry is not recognized in the producing countries. It is, in fact, even ignored in many of the consuming areas.

On the whole, the concession system in the Middle East and elsewhere has proven of great benefit to the producing countries as well as to the companies. The company profits have not been large when the downstream operations are also taken into consideration; and, if the producing

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countries were to look only at the economic benefits they could receive from the industry, it is quite likely that the present concession system would continue with only modest modifications to the end of the concessionary terms in the beginning or the middle of the next century.

However, economic considerations today seem much less important than emotion or nationalism and it seems highly likely that the countries of the Organization of Petroleum Exporting Countries (OPEC) in the next decade will demand, in addition to greater revenue per barrel of their oil, a significant degree of control over the oil companies operating in their boundaries.

The Tehran agreements signed with the oil companies in February 1971 provided for gradually increasing posted prices, and hence increased tax and royalty payments, through 1975. The OPEC countries have agreed to abide by the terms of these agreements for their full term. The current demands they are making for "participation", they say, must be considered outside the Tehran agreements and in no way are a contravention of them.

It is difficult to see the basis for this assertion in view of the Tehran agreements, and the companies are strongly disposed to resist these demands for participation, especially if it is to be without adequate compensation as current OPEC studies and statements indicate it will be.

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In the February 1971 Tehran Agreement between the oil companies and the Persian Gulf States, it was agreed inter alia that:

1) "the existing arrangements between each of the Gulf States and each of the companies to which this agreement is an overall amendment, will continue to be valid in accordance with their terms;"

2) "The following provisions constitute a settlement of the terms relating to the government take and other financial obligations of the companies operating in the Gulf States, as to the subject matters referred to in OPEC resolutions and as regards oil exported from the Gulf for a period from the 15th of February 1971 through 31st December 1975."

In short, these agreements revalidated the companies' basic concession agreements with the governments; they sta ed that the provisions of the agreement settled the governments' tax, royalties, and other financial obligations for the period to the end of 1975.

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While most companies have some hope regarding the possibility of maintaining the tax and royalty payments agreed in the Tehran/Tripoli/Baghdad Agreements, there is general agreement that after 1976, prices will go up, very likely by a substantial amount. The world will before then have entered a permanent sellers' market for oil; and the cost and availability of alternative sources of energy will be the main limiting factor for oil prices. Oil prices by that time may have gone up also in the United States to perhaps $4.50 a barrel (the present price is around $3.50/barrel; delivered cost of Persian Gulf oil on our East Coast is about $2.50/barrel at the current low tanker rate). Although world prices in '76 may not have reached U.S. domestic prices, the difference will probably be considerably smaller than it is today. Subtracting from a $4.50 price in Texas, the 25 cent transport from the fields to the Gulf of Mexico and 75 cent transport from the Gulf of Mexico to the Persian Gulf would indicate a possible selling price in the Persian Gulf of $3.50. While prices may not be quite that high, it is a possible calculation. In other words, the north coast of the Gulf of Mexico may again set world prices for oil as it did until 1950.

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As stated in the previous section, the upper limit on prices in the United States itself will probably be set ultimately by the cost of conversion of coal or shale oil. There is considerable difference of opinion on what this price will be: $4.00/barrel (in today's dollars) as some companies maintain, or $5.50 as others do. Whatever, it is, it will also set the upper limit for the price of conventional oil in the United States. At $5.50 a barrel, more conventional oil would, of course, be produced; but here too there are considerable differences of opinion on how much more oil would come out. Some companies maintain that the $5.50 oil would bring forth vast new quantities of domestic oil through discoveries made by drilling in marginal areas, by deeper drilling, and by tertiary recovery means. In fact, some maintain that this price could double or even treble our recoverable reserves. Others maintain quite the opposite, that $5.50 oil would bring forth very little additional oil production in the United States. In any case, if the cost of shale

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oil is to be $5.50, we assume that conventional oil prices will be the same and that ultimately world oil prices will probably approach the same level. In this case, we could expect $4.50 oil in the Persian Gulf.

The situation beyond January 1976, when the agreements expire, is likely to be quite different from that of today. It may be that the only way it will be possible to avert participation now will be to assure the OPEC countries, and particularly Kuwait, Saudi Arabia and Iran, that while we (the companies and the government) expect the current agreements to be honored for their full terms, serious examination would take place in the meantime as to mutually satisfactory arrangements thereafter. This approach will have a chance of success only if the companies are willing to start discussions now -- or at least quite soon -- on what these new relationships will be. Participation, of course, is not the only type of relationship which should be considered. There could, for example, be relinquishment of parts of the concession areas, and service contracts

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or joint ventures on them. Possibly if this were done, the existing concessions could continue on their reduced areas. In any case, the word "concession" should be eliminated; it has too many unfortunate connotations. "Contracts" are acceptable and imply agreement between two equals; there is an Islamic tradition to honor them and a government which would be tempted to rescind a concession might hesitate before breaking a contract.

In short, it seems likely to us that the best way of preserving a healthy international oil industry would be, in the short run, to follow the lead of those in groups 1 and 2 described in Section II above: that is, to insist vigorously on the maintenance of the Tehran agreements through 1976. Then, for the long run, to follow those in groups 3 and 4; that is, to offer to discuss now with the OPEC countries a new relationship starting in January 1976. The reasons for this essentially pessimistic conclusion will be outlined in Sections VII, VIII and XIX below. Group 5, the most pessimistic of the lot, may of course be correct; nationalization may seem inevitable. However, at no time will the nationalization of oil and converting of companies into purchasing contractors be in any way acceptable to us. We doubt that it would be in the interest of the oil producers. We cannot see how the OPEC cartel and high oil prices could be maintained in such a circumstance, and while a price war would be of immediate interest to the consumers, the advantages would be ephemeral. We cannot see how, in such a case, necessary investment would be made in the new production and export facilities which the world will need over the next decade, if state-owned oil companies are operating for themselves and in competition with each other.

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V. The Issues of Participation and Dollar Devaluation

The prime reason for the demand for participation in the oil companies is nationalism. The governments wish to be involved, perhaps to have the governing voice, in the main industry operating inside their borders. The Minister of Finance of Kuwait has said recently that "control" is the major issue and this need not necessarily mean much higher payments by the oil companies operating there. Other countries which are more short of cash than Kuwait, notably Iran and Iraq, are probably as much concerned with the increased payments as they would be with a voice in management.

The companies are very disturbed by the clear prospect, not simply of a demand for a 20 percent participation in the Gulf countries, but -- as is stated openly by many OPEC members -- that this is only a beginning and that the governments intend to end by taking 51 percent or even all of the production facilities. It might appear that this situation could be handled by many of the large integrated oil companies with shipping, refining and marketing outfits downstream. They might enter into purchasing agreements with the governments and their profits might not suffer. The smaller companies, however, with few if any marketing outlets overseas and with limited access into the United States, would very likely be ruined.

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Major companies would resist such a transformation for two reasons. The first is that, for tax purposes, they now show almost all of their profits on the production end. They count their payments to the host governments as "income tax", and subtract them as tax credit from income taxes they pay in the consuming countries. The result is that many of the large integrated companies have low effective income tax rates in the United States and elsewhere. If they were forced to show their profits downstream, the profits could be the same as they are today, but half would go in income tax. Given the companies' need for capital, this would have to be offset by higher product prices, perhaps substantially higher than those of today, and there would be severe consumer resistance. The second reason is that the companies doubt (as do we) that the producing governments, which would have many other claims on their funds, would make the necessary investments in oil to bring forth the new oil production required over the next decade or two.

In the absence of any concrete information from OPEC on exactly what the OPEC governments want or what they would settle for and when, it is difficult to make an accurate judgment on how much the participation demands would cost the companies. It is probably roughly accurate, however, to say that each percentage increase in participation could mean almost an additional cent per barrel of oil produced, assuming nominal company profits per barrel (based on posted prices) as between 80¢ and $1.00. For example, if a country asked for 20 percent participation, in Saudi Arabia this could mean an additional payment of 16¢ a

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barrel to the Saudi Government. Libya's request for 51 percent participation could mean an additional 50¢ payment to Libya. This, of course, varies from country to country and depends i.a. on costs of production. It would be much less if realized prices rather than posted prices were used as the basis for calculating company profits. *

According to recent information from OPEC, compensation to the oil companies is to be made for the book value of the assets -- which in many cases is small.** Payments are then to be made out of the profits of whatever share of the company is taken over (to ensure no decrease in government revenue) and are to be completed in a period not to exceed five years.

The company income therefore could remain essentially unaffected during the period of "compensation", or it could be reduced by whatever amount the government took for its own use. In any case, whatever

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* [redacted] believe that the basis for calculating the additional costs would be the realized prices. In this case, a demand for 20% participation in the Persian Gulf would result in a net increase in cost to the companies of only about 6 cents a barrel. The governments would then give the companies a "marketing allowance" to sell their share of the oil for them, and this 6 cents would be further reduced. The demand for 20% participation could therefore mean as little as 2 or 3 cents a barrel. In fact, it could mean no additional costs whatsoever. We doubt that the OPEC countries will start negotiations on the basis of realized prices, although it is possible that the final compromise will be somewhat on that order. In this case, there would be very little consumer resistance (as distinct from company resistance) to such an OPEC demand for participation.

** The OPEC countries will probably use figures released annually by the U.S. Department of Commerce on the value of U.S. investments abroad as the basis for their calculations.

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additional costs would be levied on the companies would have to be passed on to the consumers, as it is quite unlikely that any of the companies could absorb substantial increases any more than they could have the increases of January, 1971. As stated above, the U.S. Government will also have no choice but to protest OPEC demands for participation before the end of the Tehran agreements.

The OPEC demands for readjusting their payments as a result of the effective dollar valuation is more complex. OPEC argues that this is a case of force majeure which automatically reopened the agreements. The companies argue that the Tehran agreement escalation clause for inflation also takes care of devaluation matters.

We have informed our oil companies that we would not be able to give them active diplomatic support on this issue. They have said that they did not wish it, but have asked for permission to work together themselves in facing the OPEC demands. Department of Justice Business Review Letters have been issued to the companies to enable them to do so. We raised the matter with the Europeans and suggested that if they are disturbed on the OPEC action on this issue, they could well make their own protest to the OPEC governments. Few, if any, seem willing to do so.

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VI. Prospective Income for OPEC Governments and Balance of Payments Considerations

A. OPEC Income

The attached table gives conservative estimates of oil revenues to governments in the Middle East and North Africa in 1975. The aggregate rate of growth in production estimated is under 10 percent, well below current growth rate and rates in the past few years.

Should Middle East and North African OPEC governments succeed in forcing up the world price to the U.S. price by 1975, their estimated revenues would nearly double, from about $14.6 billion to $27 billion. The higher estimate was derived by taking the current U.S. wellhead price of about $3.30 to $3.60 per barrel, adding a factor for inflation and transportation to a U.S. coastal refining and export area and estimating this 1975 price at $4.50 per barrel. Government revenues in the Persian Gulf were estimated by deducting from $4.50 transport costs from the U.S. to the Persian Gulf, costs of production in the Persian Gulf, plus some profit or fee to producing companies and ending up with a figure of about $2.80 per barrel. The same calculation was made for government revenues in North Africa; because transportation costs to the U.S. are less from North Africa than from the Gulf, government revenue in North Africa based on U.S. prices comes to about $3.35 per barrel.

These figures must be regarded as only order of magnitude estimates. Transportation costs were assumed to be constant (which of course they

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are not) and high (worldscale 100). Lower transportation costs would increase somewhat the estimate of government revenues.

Figures for Nigeria, Venezuela, Indonesia and other producers are not included in the table. Although it has been difficult to get accurate estimates for production there, it might be reasonable to assume that production and income figures for this group would be about one-third of the totals shown in the table. Production, therefore, of the OPEC group would be about 34 million barrels per day, and income about $20 billion if the Tehran agreements are honored; $35 billion if world prices rise to the U.S. levels by 1975.

1970 and Estimated 1975 Oil Production (in thousands of barrels per day) and Government Revenues (in billions of dollars annually)

	1970		1975		
Middle East	Production	Revenue	Production	Revenue under 1971 Agreements	Revenue if World Prices based on U.S. prices
1. Iran	3,848	$ 1.1	6,500	$ 3.4	$ 6.6
2. Saudi Arabia	3,798	1.2	6,500	3.5	6.6
3. Kuwait	2,989	.9	4,000	2.1	4.1
4. Iraq	1,558	.5	2,600	1.4	2.8
5. Abu Dhabi	691	.2	1,000	.5	1.0
6. Qatar	361	.1	361	.2	.4
7. Oman	333	.1	700	.2	.4
8. Dubai	86	.03	150	.1	.2
9. Bahrain	77	.03	77	.04	.1
Total Middle East	13,741	$ 4.2	21,588	$ 11.4	$ 22.2
North Africa					
Libya	3,321	1.3	2,500	2.1	3.1
Algeria	990	.4	1,430	1.1	1.7
Total North Africa	4,311	$ 1.7	3,930	$ 3.2	$ 4.8
Total North Africa and Middle East	18,052	$ 5.9	25,518	$ 14.6	$ 27.0

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Producing governments' income in 1980 would be substantially higher. With world prices probably rising to U.S. domestic prices and those in turn set by the cost of shale or coal conversion, the net payments to governments could be as much as $3.00 per barrel and producing governments' income could be as high as $80 billion per year. This would be about ten times their 1970 income and over four times what would be expected in 1975 if the Tehran agreements are fully honored.

These projections have been discussed with the director of the new energy division of the IMF, who generally agrees with our assumptions on both future prices and volumes of oil in world trade. The Fund will soon start a study on the proportion of the OPEC income which could be expected to be returned to trade, the amounts which will be accumulated as reserves and what this will mean to international capital stability.

B. Balance of Payments Considerations

If the United States imports 12 million barrels a day of oil in 1980, and even if world prices were to remain the same as they are today, and if company remittances were not affected, the net cost to the U. S. balance of payments would be about $1.50 a barrel, or $6.5 billion a year. If, as seems much more likely, world prices rise to U.S. prices, and particularly those set by shale prices (as assumed above), the net payments to governments per barrel could be over $3.00 and the net import cost to the United States could be $3.50 per barrel. The balance of payments drain on the United States would then be $25 billion a year.

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If the oil companies continue their present existence, that is, if the oil companies could continue in some profitable form of operation, their profits will be included, and the cost per barrel to the European and Japanese consumers would therefore be marginally higher than for the United States. In the case of dramatically higher world oil prices, the net cost to most of Europe (except the UK and the Netherlands) could be close to $4.00 a barrel. If Europe is consuming 26 million barrels per day in 1980, the total cost to Europe would be on the order of $38 billion a year. If Japan's consumption is 12 million barrels a day, as seems likely (perhaps conservative), the cost to Japan could be $17 billion a year.

The great manufacturing countries could win a large portion of this back from the producing governments in increased trade, although it seems unlikely that each country's expenditures would be balanced equally with additional sales. And any such increases could be severe for underdeveloped nations who need to import their oil.

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VII. The Strengths of the Producing Governments

In 1951 at the time of the nationalization of the Anglo-Iranian Company in Iran, world oil consumption was only a quarter of that of today. Iranian production stopped, but in a very short time, was made up from the Arab countries across the Gulf, Iraq, Saudi Arabia, and particularly, Kuwait. For the next 15 years, there was considerable surplus production capacity in the world. The United States was largely self-sufficient and had perhaps 2 million barrels a day of shut-in capacity. There was also substantial shut-in capacity in most of the major producing countries of the world. This surplus gave the oil companies a great deal of security and a great deal of flexibility. With the violent overthrow of the monarchy in Iraq in 1958 and the subsequent moves against the oil companies, the companies' expansion plans for Iraq were largely abandoned, but production itself was not cut back by the Iraqi Government. The revolutionary regime of Abdal-Karim Qasim and the subsequent Arab Nationalist and Baathi regimes have all threatened to nationalize the Iraq Petroleum Company (IPC). They have not done so because they knew, or at least they feared, that the oil companies

would be able to make up Iraqi production easily outside of Iraq and, failing the cooperation of the other producers -- something they were never able to achieve -- Iraq would be left holding its own oil but with no place to market it, and therefore no income. The Iraqi Government was perennially short of cash and could not easily forego even one quarter's income from the oil production.

At the time of the Mid-East War in 1967 and the closing of the Suez Canal, there was still a considerable amount of shut-in production capacity in the Persian Gulf. But with the much longer tanker hauls there was no way this oil could be brought to market. Libya then performed the function of Kuwait in 1951; its production grew at an extremely rapid rate and world dependence on Libyan oil became acute. Shortly after the Libyan Monarchy was overthrown in September 1969, the new Libyan military Government realized that it was in its power to force new terms on the oil companies and it threatened to stop oil production unless its demands were met. These threats were far more credible than would have been those of any other country. The population of Libya was small and the Libyan Government had over $2 billion in foreign exchange to tide it over a protracted shutdown of production. It

was not at all certain, moreover, that Europe could tolerate the loss of Libyan oil. The Trans-Arabian Pipeline had been cut, and there was some evidence that the Iraqis would take advantage of any Libyan move against the companies to nationalize the IPC. This was a new situation for the consumers of oil and the companies. Never before had one country been willing or able to take on itself the burden of supply cutbacks in order to win economic gains from the companies operating there. Libya did so and the other countries of OPEC were quick to follow its lead and demand similar although usually not equal gains from the oil companies.

The situation has eased in recent months. Tanker rates have dropped and as the OPEC settlements in the Mediterranean were based on a continued high premium for short-haul oil, the Mediterranean, West African and Venezuelan oils are now overpriced, and production has dropped in all three areas. It has been made up out of the Persian Gulf. We can look with considerably more equanimity on the prospects of a confrontation with Libya than we could a year ago. Its production is now (November 1971) less than 2.5 million barrels/day while in early 1970 it had been as high as 3.8 million. If it moves

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against the companies, and should production in Libya be closed down, it should not be impossible to make up the entire amount by increasing production through the Iraqi pipeline, through Tapline (which is currently operating near 50% of capacity), and from Nigeria and Venezuela. The remainder could be made up from the Persian Gulf.

This is not entirely comforting. If any "short-haul" country were to back Libya, e.g., if Iraq were to nationalize the IPC and if the Tapline were cut, we would again face a crisis -- although not as severe as would have been the case last year with the same loss of oil.

One danger is that the apparent ease with which Libyan production could be made up will create a spirit of complacency. It is most advantageous for the consumers of oil and for the companies to be in a "buyer's market" and we do indeed appear to be in one now. It must be recognized, that this is likely to be short-lived and there is a strong probability that it may not recur.

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By 1975 world consumption will have risen so far and world production will be so concentrated in the Middle East and North Africa that two things are likely to have happened:

1) There will be so little surplus production capacity and so little storage in the world that a supply cutoff from any one of the major suppliers: Venezuela, Libya, Iran, Kuwait, or Saudi Arabia -- would provoke a supply crisis in Europe and Japan; that is five countries will find themselves in the same position as Libya did in 1970, although two of these five, Venezuela and Iran, will not have the currency reserves to withstand easily any loss of income, and

2) Most of the OPEC countries who have counted on continually increasing production -- and frequently at high rates of growth -- will be able to see, at some not too distant time, the leveling out of production and its eventual decline. OPEC as a group can therefore be expected to concentrate even more heavily than it has until now on increased payments per barrel; quite possibly there will be the first serious moves in OPEC to restrict production in order to conserve the oil for the future. The argument that the present value of oil produced in the year 1990 is nearly zero, is not impressive to many in OPEC. Whatever the theoretical merits are of such an argument, they are valid only if the income from this oil is put into productive uses, not if it is spent on luxuries or armaments.

By 1980 or 1985 at the latest, it seems likely that Venezuela, Nigeria, Algeria, Libya and Kuwait and Indonesia will all have "peaked out" or at least their primary

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production will have reached maximum sustainable levels. By 1980, unless there are dramatic, new and unexpected discoveries elsewhere in the world, only Saudi Arabia and Iraq, for a certainty, and Iran possibly will still be able to look forward to considerable increases in their production.

Production at these peaks could probably continue for several decades to come and possibly well into the next century by converting to secondary and tertiary recovery methods. This would be costly, however, and in order to make such a conversion, the governments would have to take lower revenues per barrel for their oil. This, of course, is not to say that the revenue need be lower than it is today, it would merely be lower than it would be at the time of adopting secondary recovery methods. At that time, assuming coal, shale and tar sand conversion would have set the world oil price, the producing governments could still be receiving incomes vastly greater than they are today.

With minimal cooperation inside OPEC (and the cooperation in the last year has been considerable) the OPEC countries should be able to force prices considerably higher in 1976 at the conclusion of the Tehran agreements; and at the same time will be able to force the companies to accept "participation" on OPEC terms -- in fact they could do this much earlier if they violate their agreements.

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In short, the high trumps are in the hands of the producing countries and will be for the next twenty years. The companies and the consuming governments, including our own, still have a few good cards which will be described in the next section, but they will have to be played very carefully to avoid loss of company production facilities and ever higher prices for the consumer.

The producing governments are further strengthened by the overwhelming dependence of the OECD countries, especially Western Europe and Japan, on OPEC oil. This dependence severely circumscribes the possibilities for action by consumer states. Anything they could do would have to be effective almost immediately, and most policies demand time to be implemented. Moreover, the critical economic and ideological division of the world could mean that OECD action could be impaired by actions of a coalition of less-developed nations outside of the OECD and of the countries of Eastern Europe and perhaps China.

In the face of OPEC demands to raise oil prices indefinitely or to cut off oil supplies unless higher prices are paid, the consuming countries could theoretically take less oil. However, this is scarcely a credible threat as they will have no alternatives for this oil, either from non-OPEC cources or from other types of energy, for a number of years.

Three actions have been proposed at various times on moves the consuming countries could take against the OPEC countries in retaliation

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for excessive petroleum price increases: trade embargo, the blockage of OPEC funds held in consuming nations, and elimination of aid to OPEC governments. None seems encouraging or even practical, and none will be considered further in this paper which will concentrate on more positive actions.

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VIII. Strengths of the Companies

In the past, the technology, the income, and the size of the major oil companies made them more formidable than many producing governments. The companies were often in the strong position of being able to close down production or pull out and move to more attractive fields. Their sometimes cavalier fashion in dealing with governments accounts for at least part of the hostility felt toward the companies today. But even though some company officials, and probably some consumer government officials as well, may yearn for the good old days, their strength in dealing with governments has been largely dissipated.

The companies, however, are not yet entirely deprived of power. They have three very important functions to perform:

1. The most important is as a supply and guarantor of capital.

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The capital requirements of the industry outside the Communist world in the next ten years have been estimated by Chase Manhattan Bank at over $500 billion. Of this, $180 billion will be for working capital and other general requirements, including dividends, and $360 billion will be for capital expenditures. (This subject will be discussed in another context later in the paper). Of the capital expenditures, a third, or $120 billion will be in the upstream facilities, (i.e. discovery, development and production). Some of the OPEC countries may accumulate large quantities of capital, but most, very likely will not. In any case, the local demands for capital can be expected to take precedence over the demands for increased investment in oil. If the governments were to nationalize the companies or take over control of them, it is at least possible that the existing solidarity in OPEC would vanish; and if each producer were competing against every other producer rather than the present situation where the producing governments as a whole face the industry, it is quite possible that inter-government competition would drive prices down. This would benefit the consumer and even the companies might benefit in the short run by buying the oil and then handling its transport, refining and marketing. (There is considerable evidence that the OPEC countries recognize this danger and for this reason, if no other, will permit the companies to continue in some role in production). In this case, it seems even more certain that the necessary funds would not be invested in production and the world in a very short time would face a supply crisis from which there would be no escape other than forcible reduction of consumption.

It of course could be argued that the producing governments would be mature enough to devote a sufficient portion of their income to production facilities, and it is just possible that this

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could be done in individual countries. It is less likely -- in fact it is almost inconceivable -- that any OPEC country would invest its money and production in another country, particularly if it risked losing its investment in the same manner the oil companies lost theirs.

There is also the possibility that the consuming countries could provide the capital necessary for the development of new supplies, but it is difficult to see how this could be accomplished without using the oil companies who alone have extensive experience in this field. The experiences of ENI and CFP and ERAP in production abroad cannot comfort those who hope government oil companies would provide the solution to the oil supply problem.

2. The second major strength of the industry is in the technology it masters and in the extreme complexity of the distribution and marketing of oil.

Most, if not all of the OPEC countries very likely could continue operating the oil fields in their countries today. The oil has been found and it would be relatively easy to ensure that oil would continue to be produced from existing wells. The drilling of new development wells, however, introduces new difficulties, and the discovery and development of new fields is very likely beyond the competence of most of the technicians in OPEC countries -- even in Venezuela, which is probably the most sophisticated and most advanced in technology of any OPEC country. As complex as would be the difficulties of developing new fields, these difficulties would be overshadowed by the problems of marketing the oil. There seems little doubt that this too is already recognized by the OPEC countries. The OPEC proposals for "participation" contain explicit demands that the companies themselves will continue to market the oil for them, presumably in the normal market patterns of the companies as neither the

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governments or the companies could conceivably find new markets for 20 percent of the oil produced in the OPEC countries.

3. The third point is the functioning of the companies as a buffer between producer and consumer governments.

This is of great utility to both. Producer governments can threaten and bully companies. If they were to deal with other national oil companies or with consuming governments directly, national honor would be engaged on both sides and compromise would almost certainly be even more difficult. This need not always be the case, but there is little doubt that the Tehran/Tripoli/Baghdad negotiations of the first half of 1971 were carried out with as little involvement of national honor as possible. Had governments, rather than companies, been at Tehran in January 1971, it is difficult to envisage as happy an outcome to the negotiations as was in fact achieved.

The actions of the United States Government through the Irwin Mission to the Persian Gulf, were limited a) to a statement of the adverse strategic and security aspects of a reduction or cut-off of oil supplies on the non-Communist world, including themselves, and the adverse affect such actions would have on relations with the non-Communist world, b) to a request for more negotiating time for the companies and c) to a request to an end to the constant leap-frogging of prices in OPEC. The other countries of the OECD limited themselves to backing the companies and endorsing the efforts of the United States

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There is another point which should not be overemphasized but it is at least worth mentioning. We must recognize that there are men in OPEC who are men of honor and integrity who could be expected to act in a spirit of enlightened self-interest, as is the case with the companies.

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Some OPEC governments have behaved irrationally at times, but most of them look carefully at their own economic well-being. It should not be beyond the capability of the companies or of the consuming governments, through diplomatic missions or special envoys, to convince the producers that contracts signed in good faith and based on mutual confidence should be honored and are essential if new supplies of oil are to be found and if adequate facilities are to be built for its production, refining, transportation and distribution. And it should be equally evident that producers as well as consumers would benefit from stability in the world oil market.

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IX. Alternative Sources of Energy before 1990

The estimates for production of oil from shale in the United States in 1980 vary from 100,000 to a million barrels a day, with 300,000 being generally the most optimistic ate. One company heavily involved in shale oil has told us that with a combined government-industry effort and with controls on production similar to those in wartime, 3 million barrels a day might be produced by that time. No others thought this was achievable.

Coal conversion seems no more promising in the short run. Prospects for increasing hydroelectric power in the OECD area are negligible. Atomic energy, even with a crash program, cannot significantly reduce the dependence on oil we have calculated in this time frame. More exotic forms of energy - solar conversion or hydrogen fusion - might also be important sources of energy, but neither is likely before the end of this century. The more efficient use of energy, through the MHD (Magneto-Hydro-Dynamics) or other, as yet undiscovered, methods, might also give some surcease sometime, but not yet.

It takes only a modest amount of faith to count on some dramatic new discovery or invention solving our energy problems in the 21st century. It is not responsible to assume that a deus ex machina will intervene on our behalf before 1980 or even by 1990. In fact, we must work with the proposition, a momento mori, that despite best efforts, Western Europe and Japan and possibly the United States, will not be able to overcome, in the foreseeable future (that is before 1980) their almost complete reliance on OPEC oil.

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X. Gas

This paper concerns itself primarily with oil, but a few words should be said about natural gas. It has been called the "ideal fuel". It burns cleanly and its products are carbon dioxide and water. There is no dirt, no sulphur, it is easily handled, it can be used equally in kitchen stoves and massive power generators. It has also been very cheap in the United States, as its price has been kept low by the Federal Power Commission. Existing gas sells for less than 20 cents a thousand cubic feet (MCF), and the newly discovered gas in some cases can now be sold for somewhat more than 25 cents a thousand cubic feet. This price is still much lower than oil. Even at the higher price of 25 cents an MCF, with 5,800 cubic feet of gas equal in thermal content to one barrel of oil, the equivalent price of oil would be only $1.45 cents a barrel. The present price of oil in the United States is $3.50 - $3.75 a barrel; even the spot rates in the Persian Gulf now average close to $2.00 a barrel, and the low sulphur crudes of Nigeria and Libya, with which gas could most easily be compared, sells at close to $3.00 a barrel, f.o.b.

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Natural gas reserves in the United States are dropping at an alarming rate. At present the United States consumes gas at the rate of 22 trillion cubic feet a year; and our finds of new gas are running at only half that level. In other words, our reserves are going down at the rate of 10 to 12 trillion cubic feet a year, and when total reserves are only slightly above 200 trillion cubic feet, it is scarcely exaggerated to call the situation desperate. In fact, it is agreed by the industry as a whole that supply shortages will limit consumption by 1975. As oil will be the only practicable equivalent for gas in 1980, the figures used elsewhere for oil consumption may be too low.

The gas industry maintains that the drop in new finds is in direct relationship to the artificially low price of gas in the United States, i.e., a case of post hoc ergo propter hoc. Others are not sure that this is true; they believe that a substantial increase in wellhead prices of gas would bring forth only marginally increased supplies of gas. It is absolutely essential that the industry and government determine with as great a degree of accuracy as possible what an increase in wellhead prices of gas in the

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United States would do to our gas supplies. The need for such research and determination has already been proposed by the State Department to the gas industry, the oil industry and the Federal Power Commission. A major trade journal will start a discussion of this soon.

Gas has been flared in the oil producing areas in the Persian Gulf for as long as oil has been found there. Some natural gas is now sold by Iran to the Soviet Union and some is reinjected, but still three-quarters of all the gas produced in the Persian Gulf is being flared. The oil companies have maintained that this gas is not a resource; it is produced in connection with the production of oil and cannot be used. At least ten billion cubic feet of gas are flared daily, and while it has been true that there was no market for the gas, this will change soon. Countries of North Africa, notably Libya and Algeria, which are fairly close to the European markets, are now selling liquefied natural gas (LNG) there. Algeria is banking on a large project to sell gas to the United States. The cost of this gas is quite high, compared with gas prices in the United States. Some prospective buyers of LNG have been scandalized at the proposals to sell Algerian gas in the United States

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for 80 cents a thousand cubic feet. This is indeed high when compared with delivered U.S. gas at 40 cents a thousand cubic feet. It is not at all high when converted into oil prices. Eighty cents a thousand cubic feet, after all, is only equivalent to $4.64 a barrel for oil, and low-sulphur residual fuel oil, which is far less attractive and useful a fuel than gas, is now posted in New York at $4.40 a barrel.

Gas can be made from naphtha, but the process depends on a low price for naphtha. Prices are low today, but if naphtha were gasified, the price would be driven up; the price will be driven up in any case as the petrochemical industry gradually switches to naphtha as a feedstock. More reasonable, perhaps, are the projects to convert coal or crude oil into gas. Here, however, the price for the syngas at present is $1.20 a thousand cubic feet. This is equivalent to a price of $7.00 a barrel for oil. While the advantages of gas are considerable, it is doubtful that many users (except perhaps private homes) would be able to pay such a price.

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Although the capital costs for production and export of liquefied natural gas are extremely high, the wellhead price of the gas is quite small. In Algeria, it apparently is somewhat under ten cents a thousand cubic feet. This could be raised somewhat, but it is unlikely that gas for most countries will be a source of income comparable to their income from oil.

Shipping costs are so high a proportion of total costs that gas imports from the Persian Gulf are not yet practical. In the future, with higher prices - and, particularly if the Suez Canal opens - the Persian Gulf will probably be the main source of gas as well as of oil.

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XI. New Relationship between Consumer and Producing Governments

Some consuming governments have noted that the insecurity of their oil supplies appears to spring largely from Arab hostility to the United States, which many Arabs believe actively opposes their interests to the benefit of Israel. There are those in some consuming countries [redacted] who believe that the only way their security can be preserved is to develop a new direct relationship with the producing countries which would bypass the "Anglo-Saxon" oil companies, and therefore avoid the consequences of any action the Arabs might take against the United States. This proposal [redacted] would favor the close integration of the economies of producing and consuming countries, in an effort to guarantee that an oil embargo by the producer would do at least as much damage to its own economy as to that of the consumer. This increasing mutual dependence would thereby provide adequate guarantee of stability of supply.

It seems unlikely that all of the OECD or even a major part of it would face the domestic political consequences of a total repudiation of the United States position in the Middle East. This would be a reversal of many of their own traditional policies.

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The OPEC countries are heavily dependent on capital goods imports but in almost every case they could live without them, at least for a protracted period of time -- certainly longer than the Europeans could live without the oil. The tying of any highly developed European economy exclusively to the essentially primitive economy of a less developed nation would give that nation such control over the actions of its customer that it is difficult to see how such a proposal could be defended even by the most anti-American or ardent Arabist in the consuming state's government. As the OPEC countries develop, however, this reliance on foreign goods and foreign technical assistance will grow and it is certainly to the interest of the consuming countries to assist the development of the OPEC countries. The creation of large middle classes throughout the OPEC area and the bringing of the entire population into the money economy will indeed increase these countries' reliance on the oil consuming countries, which supply goods in return. But this will be a long process, and in the interim any bilateral relationships would almost certainly be more hazardous to the consuming countries than is the

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present system of relying on a large number of oil companies to act as intermediaries in supplying their energy requirements.

The OECD countries have considered the possibility of trying to improve their relations with the producing governments by offers of aid, military assistance, or special bilateral trade advantages. [redacted]

All this having been said, it cannot be denied that the position of the consumer countries would be improved if their political relations with the producing governments were improved. It is self-evident that the position of the United States, the oil companies and the consumers would be enhanced if the political impasse in the Middle East could be resolved.

Many of the oil producers have ties to major consumers going far beyond the delivery of oil. These should be nurtured and deepened.

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XII. New Relationships Between Consumer Governments and the Companies

The commercial freedom of the oil companies in the various countries of the OECD varies from almost no restraints (beyond those on all industry) in the U.S., the UK, Germany and Benelux, to rigid controls in France or the requirement in Japan that foreign companies be in partnership with Japanese firms.

A view was advanced some time ago by some in the EEC Secretariat [redacted] that oil was too important to be left in the hands of the private companies; that the economies of every country in the OECD (except the U.S. and Canada) depended on large quantities of imported oil. All those who advanced this proposition admitted that the companies had performed admirably in the past but [redacted] flexibility was lost in the fall of 1970" when one country (Libya) threatened the world with a supply crisis and the companies were powerless to avoid it.

This argument is that the companies should be reduced to the status of "regulated public utilities." The governments would contract for the oil from the producing states, and would set the prices. The companies would transport the oil, refine it and market it but the governments would fix product prices, allowing the companies a "fair" return on their investment.

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on its capital of only 10.3 percent in 1970 -- a full percentage point below manufacturing industry in the United States.

In fact, it would appear impossible for the industry to generate the amount of capital needed for this expansion in the 1970's if profits remain at those levels. [redacted] has said that oil company profits should be allowed to increase to $0.40/barrel (they are currently $0.33/barrel in the Eastern Hemisphere and somewhat higher in the Western Hemisphere). Even if this is achieved and if 250 billion barrels are consumed in the next decade, total profits over the decade for the entire world-wide industry will be only $100 billion, a large total but only a return of 10.3% compared to the companies capital investment. Of the remainder perhaps as much as $200 billion could be covered by depreciation of assets but this would still leave at least $200 billion, or an average of $20 billion to be borrowed or raised through sale of equity for each of the next ten years. This would be almost seven times the $3 billion borrowed in 1970. Will it be possible to find these sums either through borrowing or sale of stock? It will be a high risk and the banks and investors may well find more useful outlets for their funds. If the projections published by Chase

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Manhattan are correct; if the City Bank figures can be accepted, then it would seem that [redacted] aspiration for a profit of only $0.40/barrel is modest. That is still less than one U.S. cent per gallon -- a small enough figure when compared with excise taxes of 12 cents or more a gallon in the United States and four times that in many European countries.

One intriguing prospect is that the oil producing countries could use some of their capital accumulations in the next decade to buy up new stock offerings, or even to buy up company stock during periods when the stock market is depressed. In a relatively short time the oil producers could find themselves in a very strong position in the international oil industry, and, if they wished, could even control several of the major companies.

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XIV. Conclusions

The consuming governments are in a better position today than they were last year. Stocks are high, tanker rates are down, short haul production is down, and there is considerable spare capacity in Libya, Nigeria and Venezuela. It is therefore somewhat easier to discuss OPEC demands now than it was last year.

OPEC will make two demands on the companies in negotiations which have already begun. The first is for a readjustment of payments to the producers as a result of the dollar devaluation. The companies have tried to resist this as a contravention of the Tehran agreements but will probably not succeed. It is unlikely that an agreement would mean an increase in payments to the host governments equivalent to the full effective devaluation of the dollar in terms of (say) the German mark; it seems more likely that a formula will be reached based on increased trade costs and that it will mean a percentage increase in payments to the host governments in terms of dollars.

The demand for participation is much more serious, particularly as it is not likely to be kept to the 20 percent currently asked in the Persian Gulf, but would likely be raised to a majority participation or even more. We believe that this is in contravention of

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the Tehran agreement which lasts until 1976. As such, the companies have no choice but to protest it, and we must support their position on the integrity of the Tehran agreements and seek a suitable resolution of such an impasse. We believe that success in averting a clash now depends on the willingness of the companies to consider new relationships with producing governments following the Tehran agreements in 1976.

It should be noted that most oil producing countries get no aid from us, and the world needs the oil. If the demand for participation is legislated, there would remain few options for the companies. They could, of course, insist that the realized prices rather than the posted prices be used as a basis for calculating company profits and that they be given a substantial marketing allowance for handling the oil for the national company. In this case the financial burden to the company could be lessened. In all cases of participation, as in cases of full expropriation, the United States position is that there must be "full, prompt and adequate compensation".

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XV. Proposed Actions

A. Action which might be taken by companies to preserve their positions in international production.

1) Examine new production arrangements to OPEC which could be applicable after 1976

The companies should recognize that 1976 may be the latest that they can hope to maintain their existing concessions without essential change. The end of the Tehran Agreement will almost certainly see an effort by the producing countries to obtain quantum leap in oil prices and to demand new company/government relationships if they have not previously done so. Probably the only way of resisting demands for price increases at present or participation this year or next will be to try to work out new relationships with the producing countries after 1976. This need not necessarily mean a reduction in company profits or a loss of control. It would mean giving the producing governments some voice with respect to the management of the oil industry operating inside their borders.

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2) Enlarge the composition of oil producing companies

The major part of the world's oil production is in the hands of the seven major oil companies, five of which are American, one British, and one British/Dutch. The French have a stake in Eastern Hemisphere oil production, but not much more than to cover their own needs. The major oil consumers, notably Japan, Germany and Italy, have long aspired to control some of their own production. The companies should seriously consider opening up existing concessions to companies from at least these three nations. For example, there could be an enlargement of the consortium in Iran or in Saudi Arabia. More acceptable, and perhaps more equitable, to the companies would be new joint ventures in new areas. An example of this is the new Mobil/ Japanese operation in Iran.

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.....Specific Action (1) by the Department

The Department should outline to the major oil companies and a substantial number of the independents, the Department's views on the probable developments in world oil in the next decade, possible action on their behalf (as described below), and to encourage them to consider some new relationships with the producers after 1976. This of course need not necessarily be participation in the form currently being discussed.

B. Action Taken by the USG in the United States on Behalf of the Companies

1) Form an international petroleum advisory group

This could be similar to the National Petroleum Council, which advises the Secretary of the Interior. It would advise the Secretary of State on international oil matters and could meet periodically or on an ad hoc basis. Depending on its function, such a group might require a Business Review Letter or other form of approval by the Department of Justice.

.....Specific Action (2) by the Department

When company executives visit Washington to discuss the future of the industry, the Secretary or the Under Secretary should raise this matter. It has already been discussed at a lower level with a number of officials who are interested.

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(2) Allow companies to work together to attain certain restricted goals

The United States Government should permit the companies to operate together abroad to face a unified OPEC challenge without fear of anti-trust prosecution in the United States. European and Japanese companies operate with the full backing of their governments and it is essential that the American companies are shown to be supported by the United States. This has not always been the case; in fact, some producing governments seem to have the idea that the United States will give little support to U. S. companies overseas.

Action on behalf of the companies was taken in January 1971, and again on October 22, 1971, when the companies were given Business Review Letters by the Department of Justic allowing them to present a common front to OPEC.

.....Specific Action (3) by the Department

At the request of the Department of State, the Department of Justice gave the companies Business Review Letters in January 1971, and again on October 22, 1971, which permitted them to present a common front to the OPEC. The Department

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should keep in constant contact with the Department of Justice and with key Congressmen and Senators on this matter to ensure that there is an understanding of the reasons for the action and the benefits we expect both the companies and the consumers to gain from it. This is currently being done.

C. Diplomatic Approaches on Behalf of the Companies

1) In the Persian Gulf - as a result of the Irwin Mission

If the OPEC countries persist in demands for participation now, the United States Government should give the companies appropriate diplomatic support.

.....Specific Action (4) by the Department

The Department should deliver notes [redacted]

The Department should point out the difficulties and the dangers to us, the other consumers and ultimately to the producer governments caused by demands for "participation" now, when the world had assumed that five years of stability in the oil market had been achieved in the Tehran agreement of February 1971. [redacted] could point out to the [redacted]

2) Review in the OECD the capital requirements of the industry in the next decade

.....Specific Action (5) by the Department

The Department should ask all OECD countries their views on the capital requirements and other

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financial aspects of the industry in the next decade.

3) Discuss the need for stability in the world oil market

.....Specific Action (6) by the Department

The Department should be prepared to discuss, but not necessarily support, the idea of a joint OECD approach, or an approach of selected OECD countries to some OPEC countries, for a new producer/consumer relationship such as has been raised.

4) Investment in New Sources of Oil

Europe and Japan have long been disturbed by their almost total dependence on the Middle East and North Africa for their oil. They have started the search for oil elsewhere but, with the execption of the giants (BP and Shell), they have generally been unsucessful. On of the main reasons is their lack of expertise which could be provided by American firms.

.....Specific Action (7) by the Department

The Department should raise in the next OECD meeting the desirability of diversifying our sources of oil to as great an extent as possible; we should say we welcome joint ventures of our oil companies with European or Japanese companies in the Middle East and elsewhere; in conventional oil exploration as well as the development of new types of hydrocarbons.

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5) Increase Stocks

After the Mid-East crisis of 1967, the U. S. delegate to the OECD Oil Committee urged that OECD stocks be raised to 180 days. They were theoretically 60 days at that time, but most countries fell far short of that level. Many in the OECD now ruefully admit that the U. S. was right; that if Europe and Japan had had 180 days of stocks last year, it might have been possible to have withstood the Libyan blackmail. The OECD recommended stock level has now been increased to 90 days.

.....Specific Action (8) by the Department

The U. S. delegate to the Oil Committee should raise again this matter. He should propose a storage figure of 180 days but would be prepared to settle for 120 days, and if this is impossible, then the current 90 days -- but based on forward consumption and effective stocks, i.e., tank bottoms and oil in pipelines should not be counted as stocks.

6) Accelerate the development of nuclear energy with Europe and Japan

The U. S. should continue to facilitate the development of nuclear power on a broad front including the development of international design and construction standards to meet safety and environmental requirements and to simplify licensing and regulatory procedures. In particular, the U. S. should move forward with its international efforts in enrichment cooperation as well as its domestic access program to assure that

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installation of nuclear power plants either domestically or abroad is not delayed by concern over an adequate supply of enriched uranium. The USG should take those actions necessary to put itself in a position to construct new enrichment facilities as needed. This will require the resolution within the next two or three years of mechanisms for cooperation in a multinational plant and/or procedures for construction of additional plants in the U. S. either by the government or by private industry.

.....Specific Action (9) by the Department

The Department should encourage the Administration to proceed vigorously with actions to facilitate the construction of nuclear power plants both domestically and abroad including resolution of licensing and regulatory procedures, environmental requirements, design and construction standards and provisions for the construction of additional enrichment facilities domestically and abroad to meet requirements for enriched uranium.

7) Maintain friendly relations with producing governments

.....Specific Action (10) by the Department

Maintain the programs with Saudi Arabia and Iran described in Section XIV above. Continue the present U. S. Government policy of trying to keep a balance in our relations with all states of

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the Middle East.

D. Action Taken by the USG to Increase Its Own Stability and Flexibility in Dealing with Producing Countries

1) Increase domestic supplies of oil

This could be done inter alia by:

(a) Giving immediate leases on the outer Continental Shelf. In order for these leases beyond the 200-meter depth to be consistent with the President's Oceans Policy Statement, they must be made subject to whatever international regime is established by the United Nations Law of the Sea Conference. Connected with this should be a new form of bidding based not exclusively on initial bonus payments, which enable only a few companies to participate. Offers of new tax arrangements or offers to maintain spare capacity (this may be a requisite for bidding) could be considered.

.....Specific Action (11) by the Department

The Secretary should write to the Secretary of the Interior and inform him that, while we still hoped to reach an international agreement on

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the Continental Shelf, we no longer would object to Interior's granting of petroleum leases beyond the 200 meter isobath. In order to be consistent with the President's Oceans Policy Statement, the leases must be made specifically subject to the international regime to be established by the Law of the Sea Conference.

(b) Giving leases on Naval Petroleum Reserve No. 4 in Alaska, with perhaps some requirement on maintaining spare capacity.

(c) Proceeding as rapidly as possible with the exploitation of shale oil and with coal conversion. This would mean giving leases immediately on the shale areas. It would also probably be necessary to give synthetic oil the same depletion allowances as are now given conventional oil.

(d) Encouraging the production of conventional oil and gas through new tax allowances for newly discovered oil, or for oil produced by tertiary recovery methods.

(e) Determine as accurately as possible how much more gas could be produced in the United States by raising the wellhead price of newly

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discovered gas by 10¢ increments up to delivered LNG prices. If the FPC, the Department of the Interior and the industry could demonstrate that significant quantities of gas would be produced in the United States by these higher prices, then prices should be raised. We will be forced to pay the higher prices for imported LNG and, for both security and balance of payments considerations, should produce the gas in the United States to the degree we can.

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.....Specific Action (12) by the Department:

The Department Representative on the Domestic Council Subcommittee on Energy and the Oil Policy Committee should review our concern at the projected energy shortages for 1980, and raise points (b), (c), (d), and (e) above. He should point out that the Department is, as yet, the only Department to have come out squarely for the Alaska pipeline, and should urge other Departments to make statements similar to that included in the OEP letter (quoting the Department) to the Secretary of the Interior. Department officers should discuss these same matters with the Foreign Affairs and Interior Committees of the Senate and House.

2) Encourage development of new forms of energy

Implicit in the President's Energy Message of June 4, 1971, was the conclusion that the United States

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Government would ensure that research on energy matters would receive the highest priority. There appears to have been little follow-up, however.

.....Specific Action (13) by the Department

The Secretary, in a letter to the President, should review our concern about supplies of energy, shall refer to the President's June energy message, and should ask him or his Science Advisor to state publicly that the Administration had taken a policy decision to accelerate development of new forms of energy; and that from now on, whenever science can demonstrate adequately that it needs more funds for research and development, these funds will be made available; in other words, that money will no longer be the limiting factor in the development of new energy forms.

3) Take measures to utilize energy in the United States more rationally

This would include, inter alia:

(a) Raising taxes on gasoline and freeing gasoline taxes from the Highway Fund: using these taxes then for subsidies for mass transportation.

(b) Discouraging growth in consumption of electricity by eliminating special rates for large users.

(c) Encouraging use of electricity during off-peak hours. This could be done by lowering

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rates between 6:00 PM and 6:00 AM. New metering arrangement would have to be made. This is already done in Europe.

(d) Encouraging the recycling of aluminum or the reduction in use of aluminum. Aluminum production require 15 times as much energy as does the production of the same quantity of steel. With higher rates on energy, aluminum production may, in any case, decline.

(e) Starting a national "save-a-watt" campaign to encourage Americans to keep their houses 5 degrees warmer in summer and 5 degrees cooler in winter. In connection with this, all advertising compaigns to increase the use of energy (particularly gas) should be stopped.

.....Specific Action (14) by the Department

The Department Representative should raise these matters in the Domestic Council and the Oil Policy Committee. The Department should also encourage Senators or Congressmen to introduce legislation which will accomplish these objectives.

N.B.: Legislation to remove gasoline taxes from the Highway Fund will be raised soon. We have discussed this with the major oil companies who will no longer oppose it as they have similar legislation in the past.

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(4) Coordinate energy policy

There is a growing understanding of the energy risis the United States is now entering. There is, however, no coordination in the U. S. Government on energy matters. It seems to us to be essential that some one responsible group be in charge of all energy matters: oil, gas, coal, atomic energy, and non-conventional forms of energy. The President has announced that energy matters are to be centered in the new Department of Natural Resources, a move we heartily endorse. In the interim, we believe the decision-making authority of the government should be more concentrated and more clearly defined.

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.....Specific Action (15) by the Department

The Secretary, in his letter to the President (Action-13-above), should repeat our support for the formation of the Department of Natural Resources but should suggest that we cannot wait until this is done before we take action to meet the energy crisis. As a first step, the authority of the Oil Policy Committee under General Lincoln of the OEP could be enlarged to cover other forms of energy. He would say that the Department Representative on the Oil Policy Committee will advance this view at one of the next OPC meetings.

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5) Conclude an energy agreement with Canada

This could be done on lines proposed to Canada at various times during the last year. [redacted] we could unilaterally declare that the reasons for imposing controls on Canadian oil are no longer valid (this is indeed the case), that Canadian oil will be allowed freely into the United States, providing only that oil imported into Canada not come west of the Ottawa valley line (this is already Canadian policy) and that the pipelines crossing the border into the United States maintain some spare capacity for emergencies. We would have to assume; in this case, that commercial pressures to develop the Canadian oil and gas would be sufficient to ensure their development. [redacted]

[redacted] The same arrangement might be made with Mexico.

.....Specific Action (16) by the Department

Continue present efforts to conclude an agreement with Canada. Raise the subject again with Mexico.

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6) Conclude an energy agreement with Venezuela and other Latin American producers

This would be in two parts: (1) guarantee on investments made in the Venezuelan heavy oils, and (2) U.S. permission for this oil to enter freely into the United States. Such an agreement, mutatis mutandis, might also be concluded with Colombia and Ecuador.

.....Specific Action (17) by the Department

The Department should raise with Venezuela, Colombia and Ecuador the possibility of entering into such agreements and, if so, to start negotiations leading toward their conclusion.

* * * * * *

Postlude

If actions suggested in this section are taken, the position of the United States in 1980 could be quite different from that assumed in other parts of this paper. Consumption could be only 22 million barrels/day (rather than 24 million). Domestic production could be as much as 15 million barrels/day (rather than 12 million), and imports from the Western Hemisphere could be five or six million rather than three or four million. This would leave quite manageable imports of only 1-2 million barrels/day from the Eastern Hemisphere.

Attachment:
Questionnaire

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